RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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February 27, 1980 **LETTER 777**

Feb. 15, DJIA 884.98; PTI 1203; A-D ratio –18.09
Feb. 22, DJIA 868.77; PTI 1192; A-D ratio –19.23

THE MARKET: Let's trot out an old but very useful market adage. It is that a trend is taken to continue in force until proved otherwise. We can be suspicious, we can hate the market, we can be out of the market, we can talk the market down to our friends and neighbors, but brother, we better not put out shorts until we have hard evidence that the bull trend is over and the bear is firmly in command–that is if we want to stay solvent.

The evidence has been building to the effect that the market's "internals," its guts, are tired. The advance-decline line for the 30 Dow Industrials topped out on January 21 (see last Letter, page 5). The A-D ratio for the entire NYSE (which has been sluggish for a year) peaked out on its latest unimpressive advance on January 28. The daily new highs on the NYSE recorded their peak of 224 on January 31.

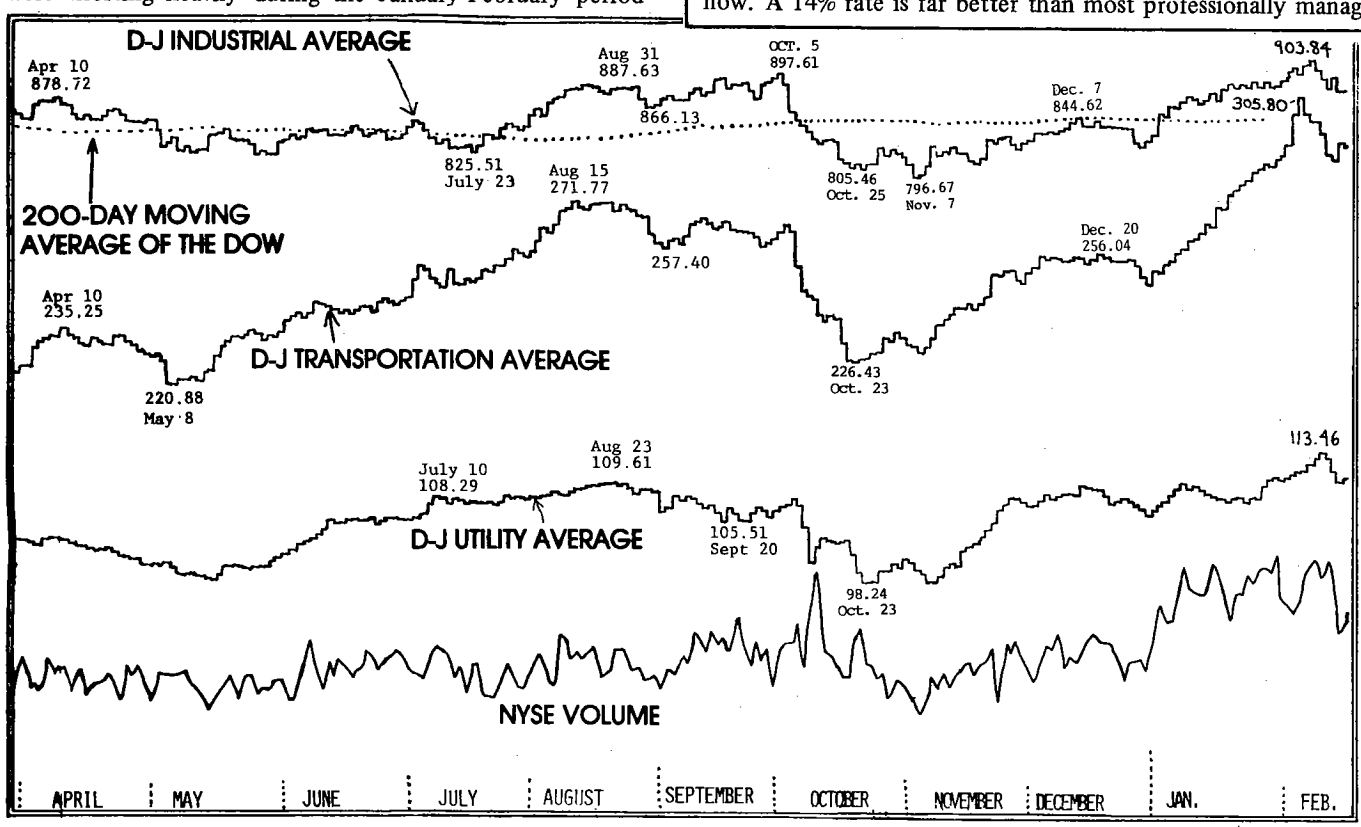
The D-J Transportation Average struck an all-time high of 305.80 on February 8. Then, as the Industrial Average ran up to a new high just above its 1979 high (to 903.84 on February 13), the Transports inexplicably fell away. In fact, on February 13 (with Industrials at their high) Transports were 8 points below their February 8 peak. By February 19 (3 trading days after the Industrial peak) Transports were at 284.96, 20 points below their record high. It was a deceptive and sloppy performance. Unfortunately, at this time we don't know whether the Averages were simply giving the bulls something to fret about–or whether they were signalling that major trouble is on the way.

We do know (the figures are two weeks late) that NYSE specialists were shorting heavily during the January-February period

FRONT PAGE COMMENT: Many subscribers have never seen markets as wild and erratic as the current ones. NYSE volume booms to record levels, oil stocks explode while the rest of the list does little, Transports rush to all-time highs (led by a few oil-related issues), then slump. Bonds crash, then crash anew. Commodities slide into bearish patterns while the wholesale price index roars at a 19% rate. Gold acts like a chicken with its head cut off, whipping first 50 points one way, then 50 the other.

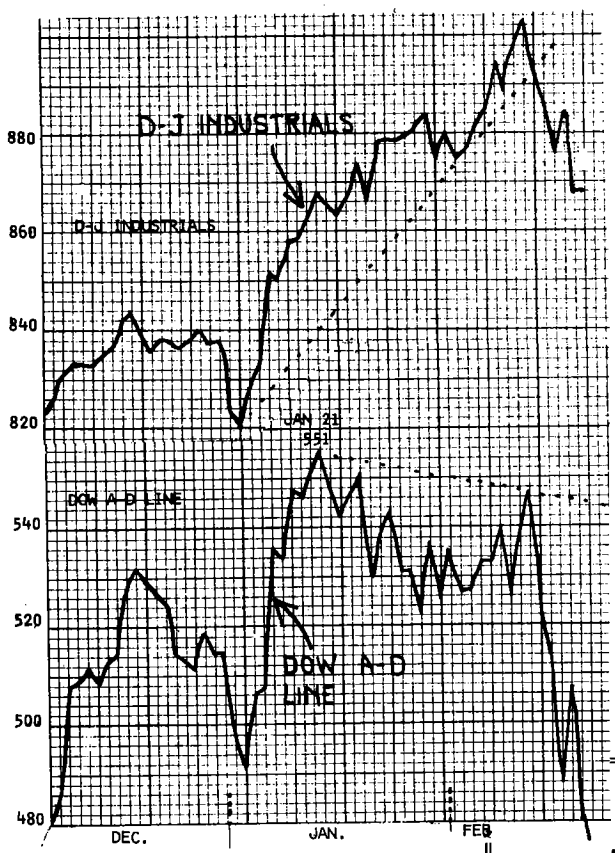
What's happening to the markets? Are exchanges across the nation suffering a nervous breakdown? What I think is happening is that the US economy is being subject to violent forces, unmeasurable forces, and these forces are basically huge (incredibly huge) pools of money trying to save themselves from the ravages of inflation and the incursions of government. Add an unstable international environment, the "shocking" emergence of Russia as the world's leading military power, a weak US President and a US monetary policy that is out of control, and you have all the elements needed to produce the most erratic markets in recent memory.

Finally, a tremendous pressure on ALL markets is the fact that US Treasury 91-day T-bills are now yielding 13.25% (figuring the discounting and the fact that there are no state taxes involved, the bills effectively yield around 14%). Trying to beat a sure 14% via stocks, commodities or anything else is difficult. It means that you MUST speculate, and that's what we're seeing now. A 14% rate is far better than most professionally managed



while members were also selling off a goodly portion of their stock inventory. These gentlemen trim their sails when they expect trouble, and they tend to be atuned to the shorter-term trend of the market (after all, they're the "house" and the house has the singular advantage of knowing what's on, or what is not on, the books).

In the last Letter I included a chart of the Dow and the Dow A-D line (which is a line showing the advancing or declining tendencies of only the 30 Dow Industrial stocks.) Last week (following a dramatic divergence) the Dow A-D line plunged below its late-January low, a low corresponding to the 820 level on the Dow. As you can see on this up-dated chart, the Dow A-D is now bearishly out-of-gear with Dow price.



As a rule, after such divergence the market gets back in harmony through the process of decline, a decline that erases the dis-harmony (i.e., the divergence). If this is to be the case, we might expect the Dow to come down and test or break the 820 level. In brief, what we see here is a picture of very *few* Dow stocks being responsible for the most recent run-up to 903.84 on the Dow. The internal Dow action during the rally was poor, however, and the chart demonstrates this fact.

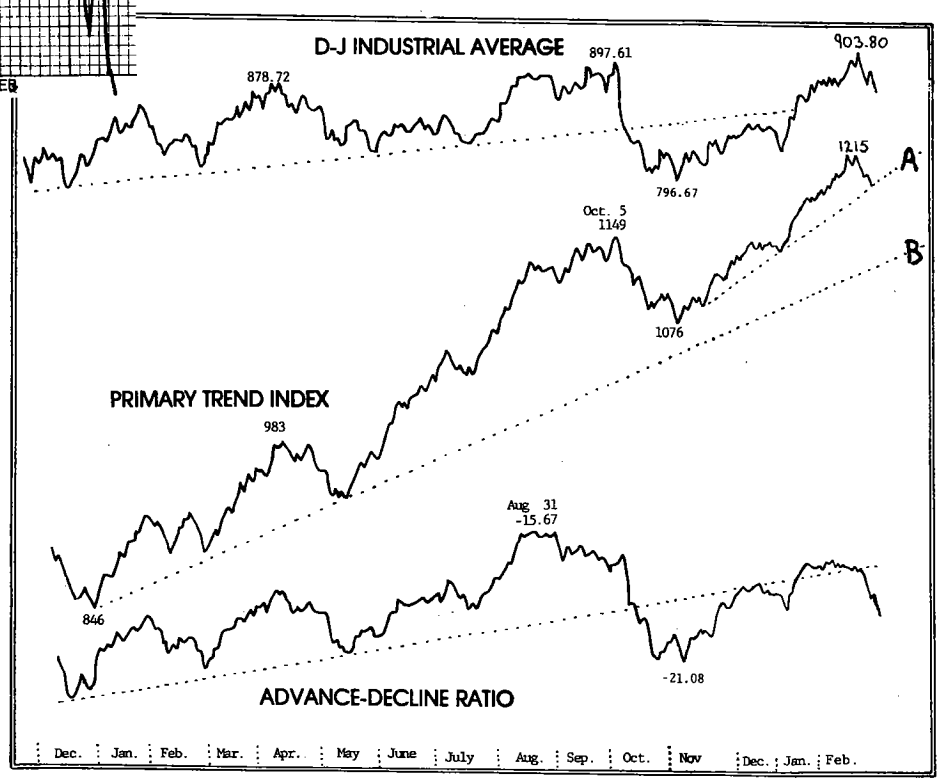
Turning to the Primary Trend Index (PTI), this composite of critical market averages and indices (chart to the right) recorded its peak value on February 8 at 1215. On that day the Dow was 895.73. The PTI dipped to 1211, then inched up to 1215 again on February 13. On February 13 the Dow established a new high of 903.84.

The February 13 instance was the first in many months in which the Industrials rallied above a previous peak **unconfirmed by the PTI.** This action reflected some technical weakness and constituted a minor sell signal. But it is the **cumulative action** of the PTI from here on that I am most interested in.

The rising PTI trendlines are obviously very important, and I want to see (during weakness) whether those trendlines hold. I am also most interested to see how that PTI acts during a rally. Will it tack on pointage, will it better its preceding high or will it turn sluggish? It's the on-going (cumulative) evidence offered by the PTI that is so crucial. That's why I call it the "Primary Trend Index" rather than the "minor trend index" or the "trading index."

As this is written, trendline "A" on the PTI chart is still intact—but just. The much more important trendline B is far from being violated.

I am glad that I have the 1973-74 action of the PTI as a case-book study. During that period the PTI never stopped going down. If we see that kind of weakness come into the PTI again the prognosis will be clear. At this point, however, we must take one step



funds can produce over any 10-year period. Thus, the money markets are making SPECULATORS out of all investors and the markets reflect it.

At this time I want to repeat two of Russell's market theorems. I want to repeat them because they may prove extremely helpful. Theorem No. 1: "The market will do whatever it has to—to drive the greatest number of people 'up the wall'." Theorem No. 2: "There's been more money lost trying to beat inflation than has ever been lost through the ravages of inflation."

Now I'm going to add a new theorem. Let's call it No. 3: "If the things you do wrong in the market are out-balancing the things you do right in the market, step back, clear out and re-think your actions and your policies. Your results are telling you that either you don't understand yourself or you don't understand the markets. Reappraise!"

at a time, and the first steps are to see whether trendlines A and B hold on further market weakness.

The A-D ratio at the bottom of the chart shows the remarkable divergence and non-confirmation between the price of the Dow and the breadth of the general market. It has been six months since the last A-D high on August 31, 1979. Any new Industrial highs (above 903.84) would simply compound the divergence and in this area we have a complex and bearish technical "problem."

HOW IT IS: In Letter 770 I presented an interview with "Mr. X," who is (in actual fact) a man I have known well for 18 years. X is in the *business* of collecting and collating facts, military, industrial, political. X is a very successful businessman. What he told me last night is so important that I wanted to present some of it here.

X told me that when the Iranian situation hit, Carter was confronted with the helplessness and weakness of the US military position. But when Afghanistan was overrun by Russia, Carter was shocked, frightened and furious. Carter had been banking on accommodation, peace, Salt II, and his own theory that the Russians wanted to get along with the US. In an instant, the ghastliness of his (Carter's) misjudgment was out in the open. Carter took Afghanistan as a personal insult. "If you want to see a 'hawk', if you want to see military spending go through the roof, then stick around and watch Carter," said X. "The new military programs are coming through at a floodtide rate. The spending is going to be unbelievable!"

"But the Russians are NOT going to let us begin to catch up," continued X. "Our military is antiquated, backward compared with Russia. While we have 2 million men in the military with 1.2 million in reserves (the US has no compulsory military training), the Russians have 3.6 million in their military with 12 million plus in reserves (Russia has compulsory military training). The comparisons are pathetic."

When Carter cut out the B-1 program, the Pentagon knew that we were heading for second class status. We had halved the Navy's shipbuilding goals, kicked out the neutron warhead, rejected surveillance of Cuba, castrated the US intelligence operation, etc. "It is now clear," continued X, "that the Russians are two generations ahead of us in missile technology. They have a missile that (from a Russian base) can hit a US target within 50 feet! That can effectively cancel all US missile capabilities except for Trident (which is carried on US submarines). We don't have a bomber. Our B-52's are 25 years old, they're flying antiques. The Russians don't even take them seriously.

The US "rapid redeployment force" is still a concept, it does not exist, it's three years away. If the Russians were to overrun Saudi Arabia tomorrow, we couldn't get more than a token force of a few thousand men there the next day. We also have no Pacific fleet to speak of, no carriers. Our Navy is woefully inadequate.

Europe sees this frightening picture (as does Japan). They are therefore backing off from close US military alignment. They want to stay neutral, and they feel their best chance for survival is accommodation with Russia. They feel the fight is between US and Russia, and they don't want to pick sides. Even as far as pulling out of the Olympics, Europe is dragging its feet, afraid of angering Russia. Only England's Thatcher and Canada have actually said "No" to the Olympics.

X says that the US timetable to get "serious" is after the election. By the same token, he believes Russia's time to get serious will be "after the Olympics." X thinks that Russia wants the Olympic propaganda very badly, and will hesitate to make its next move until after July.

"What do you think Russia wants next?" I asked X. He immediately said, "The Persian Gulf. They want the warm water port and they want the oil. It's all part of the same package." I replied, "But wouldn't that mean war with the US?" Said X, "The Russians outclass us in missiles, ships, manpower, military technology, and far and away in conventional war capabilities. How the hell are we going to take them on? It would be military suicide. They know it, Carter knows it, and the Pentagon knows it."

He continued, "Why even our surveilance capabilities are terribly inadequate. We're just now discovering new missile systems that we didn't even know the Russians had. And Lord knows what systems they may have that we DON'T know about."

"Well, what happens next?" I asked. "What do we do, lay down and die?" X said, "No, I don't know what happens next. As it stands now, I imagine we'll pretty much blabber and bluster but accommodate the Russians. The US isn't in reality about the whole situation, but here and there you are beginning to hear people talk about our very weak military position. We are squeezed between two mighty jaws, the abysmal military situation and our equally serious economic situation."

"All right," I said, "Let's say we've lost. What does losing mean?" X said, "I don't know nor does anyone else know what losing means. It would depend on the next Russian confrontation and the next and the next. If Russia takes the Mideast, that constitutes the next confrontation. If we back down, then we've lost the Mideast oil and the Western world goes into depression. Figure out the confrontations, figure out our reactions, and you'll understand what 'losing' can mean. That's all I can tell you."

"What are our chances of catching up to the Russians militarily?" I asked. "Very slim," said X. "I believe that we could only catch up to the Russians if they let us catch up—in the same way that we let them catch up to us during the 1960's and '70's. And no way do I see the Russians being willing to do that. Remember, the Russians don't have to please the population, they don't have to play politics the way US politicians do, they can go on a project full blast and they've done that in the military sphere by spending far more than we have. They're out to win, not accommodate. No, I don't think the Russians want to come over here. They don't want to personally police the US and the world. They want to **dominate** the world, and so far they have (with the help of our mis-judgments) done a good job of it."

Why did I put this interview in this Letter? Because I think it presents some of the most important facts you'll ever have to consider. I don't know if it will help you with your investing. Frankly, I think it might, but I believe this whole subject is more important than your investing. It has to do with your life and your children's lives. When Harry Schultz wrote about the "final 1000 days of the US world power," frankly, I thought he was being over-dramatic (he wrote this about two months

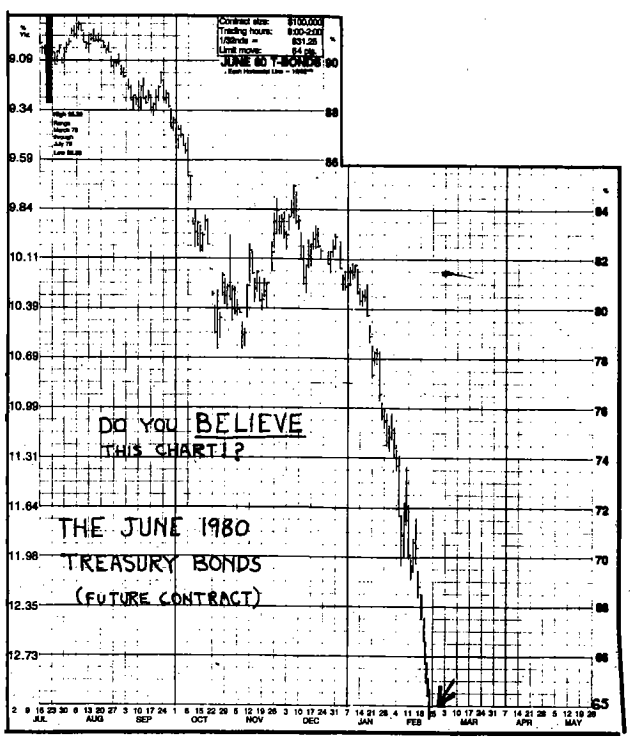
ago). Today, I don't think Harry was over-doing it. I think he was being clear and factual.

Long ago I wrote that a nation's rise or decline can be gauged by whether it is accumulating or losing gold (for whatever reason). Last night I asked X what overall conclusion he could draw from his knowledge and views. "One thing is clear," replied X, "The US is declining in power, it is sliding, sinking."

BONDS, INTEREST RATES: I've stated at many seminars and repeatedly in these reports that the single area which is most "mysterious" and incomprehensible to the average investor is that of money and money instruments. I've been talking in Letter after Letter about the rising inflation rate, the rising debt structure of this nation, and the accompanying rise in interest rates ("a sliding bond market provides the worst possible background for the stock market").

I've gone into the bond market collapse in detail, but now I'm going to continue. For the fact is that the greatest bond market crash (yes, I said crash) in US history goes on. Yields on US Government long-term bonds are moving to the 13% rate now. At 13% money QUADRUPLES in a little over 11 years! Do you understand what this means? Suppose institutions put their assets into bonds yielding 13%. That means they will be guaranteed to quadruple their assets by 1991. Where would the money come from to provide this kind of return? You say from inflation? Great, but inflation demands even higher interest rates, and higher interest rates produce an even greater rate of return and even more money is needed to service the debts. And so on–until destruction finally takes over.

Right now, we're at the point where corporations can hardly sell long-term bonds. This means they will have to go to the banks to borrow, and this adds to the illiquidity. Furthermore, in order to raise more money the banks will sell more of their bonds, and this puts further pressure on the money markets.



But the most ominous picture of all is one that I have often written about. The US Government is the biggest spender–and therefore borrower–in world history. Each quarter our Government comes out with $ 2 billion in 30-year bonds and $1.5 billion in 15-year bonds for a yearly total of $14 billion. These bonds are sold at auction–**against all bidders.** Whatever interest level it takes to sell these bonds–that's what they go for! Thus the pressure on the long-term interest rates is intense!

How can this situation end? One way is via a severe recession. A drastic recession would reduce corporate borrowing and take some pressure off the bond market. Under such circumstances, we could see a big rally in bonds as interest rates come down. Such a rally would have increased violence since it would come following an historic downside panic in the bond market.

One thing I have been wondering about is the general consensus that "there will be no recession, or perhaps a very mild recession in 1980." Frankly, I wonder if (after being held off for years) there won't be a stiff recession starting this year. If so, we could see "the big fooler." The big fooler, the contrary opinion shocker might be (1) a tumbling stock market, (2) a collapse in gold, (3) a big rally in bonds. And ultimately, a rush to CASH (for liquidity purposes) since the banks, business and the public are all extremely illiquid at this time.

Finally, this rush for cash would also represent an ironic trip-up, a contrary situation which would find most people totally unprepared. Remember, "everyone" is now borrowed up, loaded with collectibles, very low on savings and ready for more "fun and inflation." What a perfect setting for the markets to put on "the big squeeze." And the big squeeze could be a pressing need for CASH, the one thing that nobody has at this time.

Oh yes, one final thought: Up to now, cash and credit (borrowing power) have practically become synonymous. But they are not synonymous. Cash and credit may be "about the same" when confidence is riding high. When things get rough, however, the cash you have is still cash. But the credit spigot can be turned off. At that time, many will find that cash and credit are most definitely NOT the same thing.

NOTES & QUOTES: It is my opinion that the "two four-year terms" arrangement for US Presidents has to go. This year's spectacle convinces me that the present arrangement is a terrible liability. The spectacle of the President running all-out a whole year before the election is sickening. Furthermore, I cannot, for the life of me, understand why our President wants to spend another four years in the White House. He's messed up enough in his first term to last him a lifetime, and it's hard for me to comprehend why he wants to inflict his chronic shortcomings on us again.

I believe this nation should elect a President for a 6-year term with no opportunity for re-election. That might spare us another four-year political spectacle of further spending, lies and nonsense. Frankly, I don't know whether this nation is capable of surviving many more years like 1980.

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I'll be speaking at the Ruff Times 3rd Annual National Convention here in San Diego, March 13-15. It's going to be a most interesting meeting featuring William Simon, Howard Jarvis, Howard (himself) Ruff, Senator Hatch, Nicholas Deak and more. If you're ready to go call (800)642-0204 (California) or (800) 227-0703 (out of state).

My old buddy, Dr. Harry Schultz, is offering one of his rare and fascinating international seminars, this time in the Bahamas, May 15-18. For info call (609)921-8677. Harry, I wish I could

be there. The warm Bahamas waters and Schultz too–how can any sane person resist.!

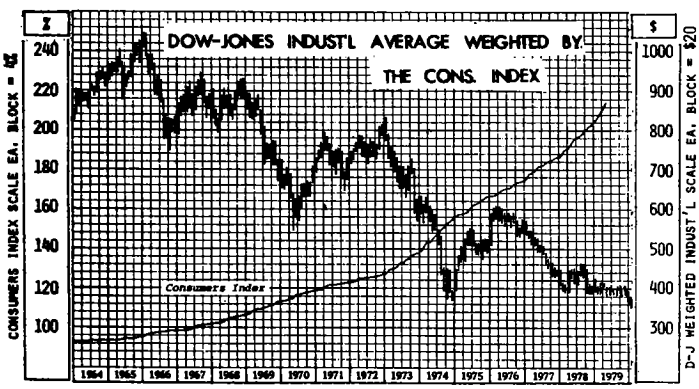
* *

If I get this Letter out it will be a triumph of man over his environment. In San Diego we usually get the whole year's rain in about a 6-week period. This year we're getting 1980 and 1981's rain in a period of two weeks! They used to joke about California dropping off into the ocean. Well, an ocean's dropping on California. We're flooded out. Flood damage estimate in the state so far–$500 million.

* *

One remarkable feature of today's markets is the lackluster performance of most commodities. The "war babies," sugar, copper and cotton have made big moves but the grain complex and the meats are dead. With inflation roaring, this has come as a total shock to most commodity traders. Frankly, I have been wondering what the "tired" grain and meat prices mean. Are they seeing something that we aren't?

Speaking of inflation, this chart (courtesy of Horsey, Salisbury, MD) shows the Dow adjusted by the Consumers Price Index or an inflation-adjusted Dow. It is clear that the big stocks just aren't "keeping up." In fact, the adjusted Dow is actually below its 1974 bottom prices. Does this mean that the Dow is a great bargain? It might. But cynics say that stocks have not taken into account replacement costs, poor productivity and phoney inventory profits. If they take all that into consideration, say the cynics, then stocks (and the Dow) are priced exactly where they should be.

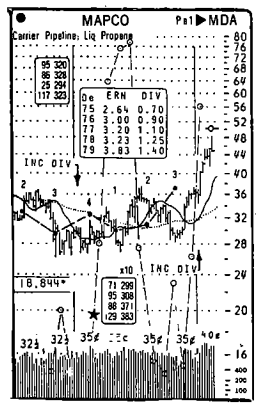


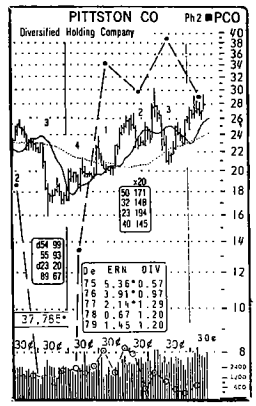
STOCKS: I always study the daily list of new highs and new lows. A glance at the new high list any day last week told you one thing–"energy and defense" is the name of the game. Of the 24 new highs for Friday, February 22, half of them were oil-related or defense-related. The list of 220 new lows for the same day told a different story. On the list was mighty Bank of America, as was J. P. Morgan and Wells Fargo, bellwethers for finance. Both Allis Chalmers and Deere were on the list, telling us something about farm financing for 1980. General Foods, Denny's and Safeway were on the list (all foods) as were many utilities (interest oriented). Perhaps most significant was General Motors at 48 7/8, and this is considered a bellwether issue. Delta Airlines and United Airlines both made the new low list and this tells me that an airline squeeze is probably coming.

For the life of me, I don't see how this nation is going to get through the 1980's without harnessing our massive coal reserves. It may take time (everything takes time in a Democracy), but ultimately we'll either harness coal or learn to live like Laplanders.

Two stocks with healthy coal interests are Mapco and Pittston. They should work out well over time. Mapco's earnings have grown at a compound rate of 12% over the last 5 years, which isn't keeping up with inflation, but what is? Pittston has about 1.5 billion tons of coal reserves, which is a lot any way you look at it (or dig at it). The charts are courtesy of Quote, PO Box 213, Wichita, Ka 67201.

BUT, wait on these. Do not buy them here. I believe we will get a better buying area ahead for stocks. In the meantime, the 91-day T-bills effectively return a safe 14% on your money when you figure the discount and the exemption from state income taxes.





LATE NOTES: It's hard to be thrilled with the latest market action. On February 22 the PTI came down to rest exactly on trendline A (see page 2 chart). Any weakness this week will therefore rupture PTI trendline A. The Dow A-D has retreated to its December 3 level (at which time the Dow was 820). The broad A-D for the NYSE has broken its December low, dropping back to its late-November level (at which time the Dow was in the 820's). New daily lows on February 22 were 229, 9.5 times the number of new highs for that day.

At this point it is glaringly clear that the Dow is far outperforming the breadth, and this presents a technical problem. Rallying tendencies in the Dow will most likely not attract broad buying from here, and thus we have the formula for a top. The key to market action from here is whether strength in the Dow will persist, thereby mitigating the weakness in the A-D. If the Dow itself weakens, I would expect the whole market to sink broadly to lower levels. Unfortunately (as I show on the page 2 chart) the breadth within the Dow itself is poor and the three Dow oil stocks plus Allied Chemical (which is partly oil) have done most of the upside work. Whether the **energy group** can keep this whole market afloat I don't know. Highly selective markets are more often than not dangerous markets. And that's about the way I view Wall Street from here.

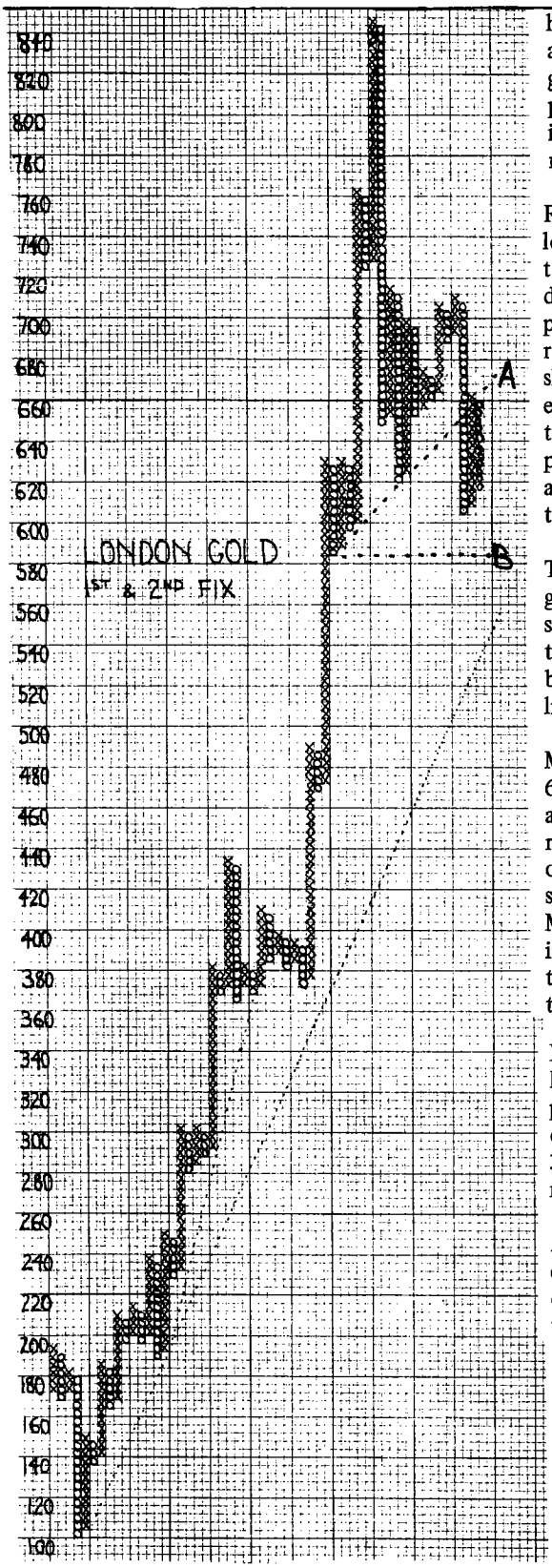
The US inflation rate is now 18%, and pressure for wage and price controls is increasing. This is self-defeating since many companies will now try to jump the gun (raising prices) to beat what they believe are coming controls. The pressure is also on the Fed to clamp down further, and Fed Chairman Volcker must be smarting at the criticism he is now receiving from all quarters ("another pussycat in the Fed"). I expect further Fed tightening, and it is probable that the bond market has been discounting this.

THREE IMPORTANT DEVELOPMENTS: (1) The dollar has now turned strong against the so-called hard currencies. Last week 6-month trendlines in the Swiss franc and the German mark were broken (reversed) in favor of the dollar.

(2) My gold/stock ratio has now dropped three weeks running in favor of stocks over gold. Furthermore, the 3-week average of this ratio is just about to drop below the 8-week ratio. This

would mean that relative strength is definitely swinging over to common stocks as against gold. But remember, this development does not mean that stocks have to go up. It means that stocks are *relatively* stronger than gold. Thus both could drop against the dollar but stocks would drop less.

(3) My negative volume index is based on the plurality of advances over declines (or vice versa) on days when NYSE volume declines against the previous day's volume. On February 22 this index came within a hair of a new low. This is telling me that although rising volume puts the market up, the rallies are NOT being sustained when the market backs off on declining volume. Thus, the "internals" of the breadth picture have turned very weak. The general market is not able to hold its gains, and if so, we can expect a further retreat on the part of most NYSE issues.



GOLD: The "theory" is that gold goes up as long as the US discount rate is going up. What this is supposed to mean is that the Fed fights inflation with the discount rate, and as long as inflation is accelerating the Fed keeps pushing the discount rate higher. It may usually work out that way, but on another level rising interest rates are the enemy of gold. Why, because as interest rates rise, the **cost** of carrying gold rises. "Oh, but I buy my gold for cash," you say. Nevertheless, when you put up your cash you are giving up interest income to hold gold. And the more interest you give up the more costly your gold position. Second, rising interest rates put on the squeeze, and the squeeze is deflationary.

Right now you're giving up around 14% per annum to hold your gold, and that's a lot. With commissions and storing charges, gold probably costs you 16% or more to hold now. At any rate, when gold hit $850 ($875 on the spot contract) it had discounted a good deal of inflation and trouble, and many holders took their profits. This point & figure chart is a 4 X 12 chart, which means that each box represents 4 points on gold, and only rallies or declines of 12 points or more are shown. What we see here is a "congestion area," and no man on the face of this earth knows whether it will ultimately prove to be a top or a bottom. To my eyes, the formation has a toppy look. We see the upward classic spike, the downward plunge, then the sideways fluctuations. Last week rising trendline "A" was broken, and gold sank to 606 (second London fix). Then the metal rallied to 660 (on the fix) and by week's end it had dropped off to the 615 area.

The battle lines are drawn. An advance to 716 (above the last peak) will turn the gold picture bullish, and set the stage for an attack on 800 again. A break below support level "B" (at 580) would seal off the top and probably send gold down towards 500 or lower. From the bulls standpoint, the best action right now would be a lengthy sideways movement in which the price movement holds above support line B.

My exponential moving averages of gold are rather interesting (see last week's page 6 chart). The 5-week moving average for gold is now 657, the 13-week MA is 606 and the 50-week MA is 427. The 5-week MA has now dropped three weeks in a row. The distance between the 5-week and the 13-week MA's hit a peak of 138 on January 18 (peak of momentum), but the distance has been contracting ever since. Last week it shrunk to 50 points. Gold under 650 will keep the 5-week MA coming down. Gold under 600 is potentially bearish. Gold under 580 would indicate to me that a major top had formed. Gold at 716 or better would hand the ball back to the bulls. But as I see it now, the burden of proof for gold falls to the bulls.

Remember, my view is that the second phase of the bull market is over for gold. Following the second phase, there should be a correction which should serve to put gold back into strong hands again. No one knows what it will take (on the downside) to move the late-comers out. It could be 600 or 590, or it could be 380-400. Only the market knows, and I do my best to "read" the messages the market sends me.

As for tactics, I would keep your 10% to 15% in gold coins but I would not hold excessive amounts of gold here. When this correction is over, we should get a good opportunity to load up on gold again. Furthermore, I believe there will be a sensational play to come in the "penny" North American gold shares.

Those who want to know more about N.American mining issues might contact John McFalls of the Value-Action Advisory, 3838 48th Ave NE, Seattle, Wash. 89105. John also offers his "Voice of Gold" tid-bits via telephone at (206) 525-7810.

NEXT MAILING: March 12th